

Report
of the
Examination of
Hallmark Insurance Company, Inc.
Bala Cynwyd, Pennsylvania
As of December 31, 1997

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March 5, 1999

Honorable Alfred W. Gross
Chairman, Financial Condition (EX4)
Subcommittee, NAIC
Commissioner of Insurance
Commonwealth of Virginia
1300 East Main Street
Richmond, VA 23218

Honorable Alfonso E. Mastrostefano
Secretary, Northeastern Zone I, NAIC
Superintendent of Insurance
State of Rhode Island and
Providence Plantations
233 Richmond Street, Suite 233
Providence, RI 02903-4233

Honorable Connie L. O'Connell
Commissioner of Insurance
State of Wisconsin
121 East Wilson Street
Madison, WI 53702

Honorable Sally McCarty
Secretary, Midwestern Zone III, NAIC
Commissioner of Insurance
State of Indiana
311 W. Washington Street, Suite 300
Indianapolis, IN 46204-2787

Commissioners:

In accordance with your instructions, a compliance examination has been made of the
affairs and financial condition of:

HALLMARK INSURANCE COMPANY, INC.
Bala Cynwyd, Pennsylvania

and this report is respectfully submitted.

I. INTRODUCTION

The previous examination of the company was conducted in 1993 as of
December 31, 1992. The current examination covered the intervening period ending
December 31, 1997, and included a review of subsequent transactions as deemed necessary to
complete the examination.

The examination was performed in conjunction with the Pennsylvania Department of
Insurance's examination of United National Insurance Company, an affiliate, which is the lead
company in the affiliated pool in which Hallmark Insurance Company, Inc., is a participant.
Significant reliance was placed on examination procedures performed by the Pennsylvania
Department of Insurance with respect to the affiliated reinsurance pool.

The examination consisted of a review of all major phases of the company's operations, and included the following areas:

- History
- Management and Control
- Corporate Records
- Conflict of Interest
- Fidelity Bonds and Other Insurance
- Employees' Welfare and Pension Plans
- Territory and Plan of Operations
- Affiliated Companies
- Growth of Company
- Reinsurance
- Financial Statements
- Accounts and Records
- Data Processing

Emphasis was placed on the audit of those areas of the company's operations accorded a high priority by the examiner-in-charge when planning the examination. Special attention was given to the action taken by the company to satisfy the recommendations and comments made in the previous examination report.

The section of this report titled "Summary of Examination Results" contains comments and elaboration on those areas where adverse findings were noted or where unusual situations existed. Comment on the remaining areas of the company's operations is contained in the examination work papers.

The company is annually audited by an independent public accounting firm as prescribed by s. Ins 50.05, Wis. Adm. Code. An integral part of this compliance examination was the review of the independent accountant's work papers. Based on the results of the review of these work papers, alternative or additional examination steps deemed necessary for the completion of this examination were performed. The examination work papers contain documentation with respect to the alternative or additional examination steps performed during the course of the examination.

Independent Actuary's Review

Since 1985, the company has been a participant in a comprehensive reinsurance pooling agreement with United National Insurance Company and Diamond State Insurance Company. In consequence, while the company's annual Statement of Actuarial Opinion has been rendered on an independent basis, the company's net loss and loss adjustment expense reserves are the product of the reserves of the United National Group Pool and the company's participation percentage in the pool.

An independent actuarial firm was engaged under a contract with Pennsylvania's Department of Insurance in connection with the Commonwealth of Pennsylvania's examination of United National Insurance Company. This independent actuarial firm reviewed the adequacy of the company's loss reserves and loss adjustment expense reserves. The results of the independent actuarial firm's work were reported to the examiner-in-charge. As deemed appropriate, reference is made in this report to the actuarial firm's conclusion.

II. HISTORY AND PLAN OF OPERATION

Hallmark Insurance Company, Inc. (hereinafter also “Hallmark” or the “company”) is the successor to a corporation of the same name organized on February 2, 1961, and having commenced business on December 16, 1961. This original Hallmark was based in Madison, Wisconsin, and later, in Middleton, Wisconsin. It wrote short-term insurance for hunters, sportsmen, athletes, and travelers, including accidental medical expense, short-term disability, accidental death and dismemberment, and legal liability. The common shares of Hallmark were publicly traded. Effective January 1, 1967, the company assumed all of the outstanding property and casualty business of the Wisconsin Insurance Corporation of America, of Madison, Wisconsin, thereby diversifying its book of business while actively continuing its former activities.

CIC Financial Corporation (hereinafter also “CIC”), an insurance holding company based in Chicago, Illinois, acquired financial control of Hallmark by August 31, 1977, through a tender offer of \$2 per common share. Eventually, CIC acquired approximately 96% of the outstanding common shares of Hallmark. After the acquisition, Hallmark was restructured to write commercial property policies in Illinois and Wisconsin, with the home office remaining in Middleton, Wisconsin. The corporation’s plan of operation was to complement the lines of Casualty Insurance Company, a wholly owned insurance subsidiary of CIC domiciled in Illinois.

In September 1982, The Continental Corporation, of New York, New York, acquired CIC under an Agreement and Plan of Merger dated June 28, 1982. On April 29, 1983, through a complex series of mergers and corporate reorganizations, Hallmark Insurance Company, Inc., was merged into a newly created Wisconsin insurer, CI-Wisconsin Insurance Corporation, with the latter company surviving.

CI-Wisconsin Insurance Corporation, a wholly owned subsidiary of The Continental Corporation, was incorporated on August 9, 1982, under Chapter 611 of the Wisconsin Statutes. It commenced business on April 29, 1983, effective with the final merger transaction with the original Hallmark. This final merger transaction dissolved the existence of the original Hallmark as an independent entity and cancelled all of its issued and outstanding common stock. Outstanding common shares of Hallmark then owned by the public, representing approximately

4% of the total shares outstanding, were converted into the right to receive \$3 in cash per share (without interest) from the surviving corporation. The surviving CI-Wisconsin Insurance Corporation changed its name to Hallmark Insurance Company, Inc., concurrent to the final merger transaction.

The management and office location of Hallmark did not change initially after the acquisition of ultimate control by The Continental Corporation. However, efforts to achieve profitability in its commercial property business were unsuccessful. Hallmark had experienced underwriting losses since its acquisition by CIC in 1977. Pursuant to s. 611.78, Wis. Stat., Hallmark reinsured all outstanding liabilities for policies and contracts of insurance with the Continental Insurance Company effective July 1, 1983. All of Hallmark's employees, with a few exceptions, were terminated and the Middleton, Wisconsin, home office was closed. Sufficient assets were retained in Hallmark to maintain the insurer's licenses in good standing and to meet obligations to general creditors.

Diamond State Insurance Company (hereinafter also, "Diamond State") purchased Hallmark as a shell from The Continental Corporation on March 7, 1985.

In this way, Hallmark became a fifth-tier subsidiary of American Manufacturing Corporation (Pennsylvania), and ultimately under the effective control of the various trusts that control American Manufacturing Corporation. On June 30, 1997, the holding company system was restructured to remove American Manufacturing Corporation (Pennsylvania) and American Manufacturing Corporation (Delaware) from the succession of control. This was accomplished through a dividend of the outstanding shares of American Insurance Service, Inc., to the private related family trusts that own American Manufacturing Corporation (Pennsylvania). The ultimate control of the various trusts continues to be exercised through American Insurance Service, Inc. Additional information concerning the holding company system is contained in the section of this report titled "Affiliated Companies."

Hallmark's operations are coordinated from the home office of United National Insurance Company, in Bala Cynwyd, Pennsylvania. The company has no employees of its own. All operations of the company are conducted with staff provided by United National Insurance

Company, numbering 184 employees at year-end 1998. United National Insurance Company initially pays nearly all expenses on the company's behalf, except for claims, premium refunds, custodial fees, and bank charges. Accordingly, intercompany balances are created in the ordinary course of business, with settlements made quarterly. Salaries, payroll taxes, travel and related items, office rent, and meals and entertainment not otherwise allocated to travel and related items are allocated among the three insurers of the United National Group. Such expenses are allocated according to the proportion that Hallmark's gross direct written premiums bear to the total gross direct written premiums of United National Insurance Company, Diamond State Insurance Company, and Hallmark combined. All other expenses are allocated on the basis of specific identification. The company files its federal income tax returns on a consolidated basis with its affiliates, including the subsidiaries of American Manufacturing Corporation (PA) and American Insurance Service, Inc., pursuant to a written tax-sharing agreement effective January 1, 1997. Written agreements with affiliates are further described in the section of this report titled, "Affiliated Companies."

At the conclusion of fieldwork for this examination on March 5, 1999, the company was licensed in Illinois, Indiana, and Wisconsin. There were license applications pending in Georgia and New York. In addition, the company does business in Oklahoma and Pennsylvania on a surplus lines basis.

In 1997, the distribution of direct premiums written in 1997 by state was as follows:

Illinois	\$3,124,078	57.4%
Pennsylvania	1,843,563	33.9
Oklahoma	410,771	7.6
Indiana	57,000	1.0
Wisconsin	<u>3,526</u>	<u>0.1</u>
Total	<u>\$5,438,938</u>	<u>100.0%</u>

In the state of Wisconsin, the company is licensed to transact the following lines of business as defined by s. Ins 6.75 (2), Wis. Adm. Code:

- (a) Fire, Inland Marine, and Other Property
- (b) Ocean Marine
- (d) Liability and Incidental Medical Expense
- (e) Automobile and Aircraft
- (f) Fidelity
- (g) Surety
- (k) Worker's Compensation
- (n) Miscellaneous

The following table is a comparative summary of direct premiums written in 1992 and 1997. Additional information concerning the growth of the company is presented in the Financial Data section of this report.

Line of Business	1992 Direct Premium	1992 Percent	1997 Premium	1997 Percent	Percent Change in Premium
Fire	\$ 236,754	3.5%	\$181,795	3.3%	(23.2)%
Allied lines	45,986	0.6	20,260	0.4	(55.9)
Homeowner's multiple peril	1,061,178	15.5	511,465	9.4	(51.8)
Commercial multiple peril	393,751	5.8	623,058	11.5	58.2
Inland marine	68,091	1.0	22,928	0.4	(66.3)
Other liability - occurrence	4,687,439	68.6	711,542	13.1	(75.7)
Other liability - claims made	*	0.0	426,494	7.8	N/A
Products liability - occurrence	33,145	0.5	0	0.0	(100.0)
Products liability - claims made	*	0.0	0	0.0	N/A
Commercial auto liability	0*	0.0	2,535,242	46.6	N/A
Auto physical damage	304,432	4.5	405,593	7.5	33.2
Surety	<u>0</u>	<u>0.0</u>	<u>560</u>	<u>0.0</u>	N/A
Total All Lines	<u>\$6,830,776</u>	<u>100.0%</u>	<u>\$5,438,938</u>	<u>100.0%</u>	<u>(20.4)%</u>

* The 1992 annual statement did not include line of business designations for "other liability - claims made," "products liability - claims made," and "commercial auto liability" in 1992. For purposes of this presentation, the percent change in premium for "other liability - occurrence" includes the 1996 premium shown for "other liability - claims made" in order to permit a more reasonable period to period comparison.

The company is a program underwriter, soliciting and accepting entire books of business from its producers. Except for its affiliate, J. H. Ferguson & Associates Inc., all of the company's producers act as third-party administrators for premium collection and occasionally also, claim adjustment and settlement. The compensation of each producer is individually negotiated.

The company refers to its producers, other than J. H. Ferguson & Associates Inc., as “managing general agents,” though they may or may not be classified as such in the legal sense of that term. The company has two types of managing general agents, traditional and specialty. Under a traditional managing general agency arrangement, specific binding authority and underwriting limits are established for the specific producer according to that producer’s perceived level of expertise. A specialty managing general agency arrangement involves a reinsurer. Since each specialty program involves different risks, a separate and distinct managing general agency contract is drawn up and matched with a reinsurance treaty that was designed to handle the risks described in the managing general agency contract. Accordingly, the number of contracts that exist between the company and a producer depends on how many programs that producer administers.

Each program, whether traditional or specialty, is assigned to an underwriter employed by United National for supervision. The underwriter’s responsibility is to ensure that the managing general agent is underwriting business that conforms to the specifications and intent of the contract, and, if applicable, to the reinsurance treaty established to handle the risks of the program. Although the risk is bound, every policy in every program is re-underwritten by the underwriter assigned to the program. In addition, the designated underwriter verifies that policies are written in sequential order, attached with the appropriate endorsements, and are not being backdated by the managing general agent. The underwriter also verifies that premiums on individual policies are being charged appropriately. Underwriters do on-site inspection of every managing general agent from one to four times per year.

At the time of this examination, the company had 28 appointed agents or agencies in Illinois, Indiana, and Wisconsin, the jurisdictions in which it acts as an admitted carrier. During 1997, the company derived premium from 24 producers, including one, Integrity Underwriters, of Harrisburg, Pennsylvania, that met the legal definition of a managing general agent pursuant to s. Ins 42.01 (3), Wis. Adm. Code. Integrity Underwriters is the name of a related group of companies, which includes Integrity Managers, Inc., and Integrity Administrators. In 1997, Integrity Underwriters wrote \$3,113,532, or 57.2%, of the company’s \$5,438,938 direct premiums written.

III. MANAGEMENT AND CONTROL

Board of Directors

The board of directors consists of nine members. All directors are elected annually. Officers are elected at the board's annual meeting. Members of the company's board of directors are often members of other boards of directors in the holding company system.

Compensation for service on the various boards of the United National Group varies among the board members. Mr. Kaufman and Mr. Baney, the independent directors, receive \$35,000 and \$20,000 per year, respectively, for their work on the boards of the United National Group. Mr. Raymond L. Freudberg receives \$2,000 per year. Mr. Seth D. Freudberg and Mr. Kevin L. Tate each receive \$1,000 per year. The other members of Hallmark's board receive no compensation for service specific to Hallmark Insurance Company, Inc., or other insurers within the United National Group.

Of the compensation paid to its directors, Hallmark is allocated only a portion of the fees paid to Mr. Seth D. Freudberg and Mr. Kevin L. Tate. No portion of the other directors' fees was allocated to Hallmark at the time of this examination.

At the conclusion of fieldwork for this examination, the board of directors consisted of the following persons:

Name and Residence	Principal Occupation	Term Expires
Raymond L. Freudberg Rydal, Pennsylvania	Chairman of the Board United National Insurance Company and Subsidiaries	2000
Seth D. Freudberg Wynnewood, Pennsylvania	President, Chief Executive Officer, and Chief Operating Officer United National Insurance Company and Subsidiaries	2000
Russell C. Ball III Haverford, Pennsylvania	President and Chief Executive Officer American Manufacturing Corporation	2000
John E. Baney Key Largo, Florida	Owner J. E. Baney Holdings	2000
Norman M. Berger Wynnewood, Pennsylvania	Of Counsel, Galfand, Berger, Lurie, Brigham, Jacobs, Swan, Jurewicz & Jensen, Ltd.	2000

Gustav A. Kaufman Baltimore, Maryland	Retired Chief Executive Officer The Equipment Leasing Company	2000
Richard S. March Cherry Hill, New Jersey	Senior Vice President, General Counsel, and Assistant Secretary United National Insurance Company and Subsidiaries	2000
Robert H. Strouse West Chester, Pennsylvania	Executive Vice President American Manufacturing Corporation	2000
Kevin L. Tate Newtown Square, Pennsylvania	Senior Vice President, Treasurer, Chief Financial Officer, and Assistant Secretary United National Insurance Company and Subsidiaries	2000

Committees of the Board

Section 3.12 of the company's bylaws require the appointment of executive and finance committees, and allow the formation of such other committees as the board may desire. Directors receive no compensation specific to their service on committees. The committees at the time of the examination are listed below:

Executive Committee

Raymond L. Freudberg, Chair
Seth D. Freudberg
G. Arnold Kaufman

Finance Committee

Seth D. Freudberg, Chair
G. Arnold Kaufman
Robert Strouse

Officers of the Company

Officers with the rank of vice president or higher who were elected by the board of directors and serving at the time of this examination are listed on the next page. United National Insurance Company pays all of the company's officers. Executive compensation expenses are then allocated among members of the affiliated holding company system in accordance with the terms of the cost allocation agreement effective June 30, 1997.

Name	Office	1998 Salary	1998 Bonus	Other 1998 Compensation
Raymond L. Freudberg	Chairman of the Board	\$193,238	\$ 0	\$ 2,000
Seth D. Freudberg	President, Chief Executive Officer, and Chief Operating Officer	300,000	138,193	1,000
Robert Cohen	Senior Vice President – Marketing	180,000	54,653	0
Richard S. March	Senior Vice President General Counsel, and Assistant Secretary	250,000	83,920	0
Kevin L. Tate	Senior Vice President, Treasurer, Chief Financial Officer, and Assistant Secretary	173,569	55,562	1,000
William F. Schmidt	Senior Vice President and Chief Underwriting Officer	170,000	0	58,844
Timothy J. Dwyer	Vice President – Accounting and Controller	97,577	0	0
John C. Freeston	Vice President – Systems	114,800	27,264	0
Jerry E. Hart	Vice President – Claims	144,459	29,585	0
Linda C. Hohn	Vice President and Associate General Counsel	32,250	0	0
Joanne Schmal Pawulack	Vice President – Underwriting	128,500	21,388	149,888
James H. Pye III	Vice President – Underwriting	76,077	0	64,819
Viola House Clements	Vice President – Underwriting	75,000	0	0
John F. Yaglenski, Jr.	Vice President & Assistant Secretary	0	0	0
Jonathan P. Ritz	Vice President – Marketing	120,827	50,000	0
Lynne Gerber-Saionz	Vice President, Senior Associate Counsel, and Secretary	97,000	0	0

Note: The company failed to file the report on executive compensation, a Wisconsin supplement to its 1997 annual statement, as required by ss. 601.42 and 611.63 (4), Wis. Stat. Further comment is contained in the section of this report captioned, "Report of Executive Compensation."

IV. AFFILIATED COMPANIES

Hallmark Insurance Company, Inc., is a member of a multi-industry holding company system under the ultimate control of various trusts (hereinafter also the “Ball Family Trusts”). The holding company system can be regarded as consisting of a manufacturing group and an insurance group. The insurance group is commonly known as the United National Group.

The manufacturing group is led by American Manufacturing Corporation (hereinafter also “AMC”), a closely held corporation domiciled in Pennsylvania. AMC, formerly known as Philadelphia Gear Corporation, has 17 wholly owned direct or indirect subsidiaries and holds significant interests in another 6 corporations, one Delaware limited liability company, one limited partnership, and a Mexican land trust. These subsidiaries and interests are variously domiciled in Delaware, Pennsylvania, Texas, Virginia, Washington, Canada, Mexico, Saudi Arabia, Singapore, and the United Kingdom. AMC, through itself or its subsidiaries and interests, is a diversified manufacturer and distributor of industrial gears and mixers, valve actuators, electronic safety systems, cordage, and home organizer products.

The United National Group is nominally led by American Insurance Service, Inc. (hereinafter also “AIS”), a closely held corporation domiciled in Pennsylvania. AIS has seven downstream subsidiaries, including four insurers. These subsidiaries are domiciled in Pennsylvania, Indiana, Illinois, Wisconsin, and Barbados. The United National Group insures, and provides ancillary insurance services to, the property and casualty market, with emphasis on commercial risks written on a surplus lines basis.

Due to the number and variety of interests controlled by the Ball Family Trusts, this report will confine its narrative of specific entities to parents in the direct succession of control of Hallmark Insurance Company, Inc. Hallmark does not have significant reinsurance, investment, or service relationships with any affiliate that is not in its succession of control. An abbreviated chart of holding company relationships, limited to the insurance group of the holding company system, is presented later in this section of the examination report.

Succession of Control

The Ball Family Trusts

The following trusts are the ultimate controlling persons of the holding company system:

- a. Francis J. Mirabello, Charles Slingoff, Jr., and PNC Bank, N.A., Trustees under agreement of trust of Russell C. Ball, Jr., dated June 9, 1969
- b. PNC Bank, N.A., Russell C. Ball III, and Andrew L. Ball, Trustees, under Will of Russell C. Ball, Sr., as appointed by Russell Ball, Jr., for the benefit of Russell C. Ball III
- c. PNC Bank, N.A., Russell C. Ball III, and Andrew L. Ball, Trustees, under the Will of Russell C. Ball, Sr., as appointed by Russell Ball, Jr., for the benefit of Andrew L. Ball.
- d. PNC Bank, N.A., Russell C. Ball III, and Andrew L. Ball, Trustees, under agreement of trust of Ethel M. Ball dated February 9, 1967, as appointed by Russell C. Ball, Jr., for the benefit of Russell C. Ball III
- e. PNC Bank, N.A., Russell C. Ball III, and Andrew L. Ball, Trustees, under agreement of trust of Ethel M. Ball dated February 9, 1967, as appointed by Russell C. Ball, Jr., for the benefit of Andrew L. Ball

These trusts were established as irrevocable trusts to make provision for the descendants of their respective grantors. The trusts are complex trusts and, therefore, subject to federal income taxes to the extent that there is an accumulation of income or the occurrence of capital gains which are recognized as taxable under the Internal Revenue Code. The primary asset of the trusts is the closely held common stock of American Manufacturing Corporation and American Insurance Service, Inc.

The fund balances reported for these trusts in their respective audited financial statements as of December 31, 1997, the latest date for which financial information was available, were as follows:

The Russell C. Ball Trust	\$ 72,196,841
The Russell C. Ball Trust II	72,186,739
The Russell C. Ball, Jr. Trust	65,379,795
The Ethel M. Ball Trust	54,007,612
The Ethel M. Ball Trust II	<u>54,007,588</u>
Total	<u>\$317,778,575</u>

American Insurance Service, Inc.

American Insurance Services, Inc. was incorporated under the laws of the Commonwealth of Pennsylvania on June 2, 1972. It was formed as a holding company for the insurance and insurance-related subsidiaries of American Manufacturing Corporation (Delaware). From its inception until June 30, 1997, AIS remained a wholly-owned subsidiary of American Manufacturing Corporation. Effective July 1, 1997, AIS was transferred to the ten shareholders of American Manufacturing Corporation (Pennsylvania) in a tax-free spin-off.

In its consolidated financial statements, audited under generally accepted accounting principles, AIS reported assets of \$1,145,130,000, liabilities of \$890,601,000, and shareholders' equity of \$254,529,000. Operations for 1997 produced a net income of \$42,529,000.

United National Insurance Company

United National Insurance Company (hereinafter also "United National") was incorporated under the laws of Pennsylvania on May 27, 1960, and commenced business on December 31, 1960. United National writes commercial property and casualty insurance, primarily on a surplus lines basis. The corporation is licensed only in Pennsylvania, but it operates on a surplus lines or nonadmitted basis in every other state, the District of Columbia, Puerto Rico, and the Virgin Islands. United National has an 80% participation in the affiliated pooling agreement, whereby all business written by the United National Group is combined and reapportioned. The 1997 statutory annual statement reports assets of \$428,644,976, liabilities of \$195,233,735, policyholders' surplus of \$233,411,241, and net income of \$32,274,190. United National was examined concurrently with Hallmark as of December 31, 1997, and the results of that examination were expressed in a separate report issued by the Pennsylvania Department of Insurance. The corporation is a wholly owned subsidiary of American Insurance Service, Inc.

Diamond State Insurance Company

Diamond State Insurance Company was incorporated under the laws of Delaware on February 20, 1981, and commenced business on April 1, 1982. On July 13, 1992, the corporation was redomesticated from Delaware to Indiana. The corporation provides coverage on commercial and homeowners risks. Diamond State is licensed in the District of Columbia and all

states except Alaska, Hawaii, Illinois, Pennsylvania, and Wisconsin. It also operates on a surplus lines basis in Pennsylvania. Diamond State has a 10% participation in the affiliated pooling agreement, whereby all business written by the United National Group is combined and reapportioned. The 1997 statutory annual statement reports assets of \$62,175,000, liabilities of \$21,593,098, policyholders' surplus of \$40,581,902, and net income of \$3,981,742. Diamond State was examined concurrently with Hallmark as of December 31, 1997, and the results of that examination were expressed in a separate report issued by the Indiana Department of Insurance. The corporation is a wholly owned subsidiary of United National.

Written Agreements with Affiliates

As previously noted, the company has no employees of its own. All day-to-day operations are conducted with staff provided by United National Insurance Company in accordance with the business practices and internal controls it maintains with respect to its employees. In addition to common staffing and management control by United National Insurance Company, Hallmark's relationship to its affiliates is affected by five written agreements. Reinsurance agreements are described in the reinsurance section of this report. A brief summary of the other three agreements follows.

Cost Allocation Agreement

Effective June 30, 1997, United National Insurance Company, Diamond State Insurance Company, and Hallmark Insurance Company, Inc., entered into a cost allocation agreement. Under this agreement, United National agrees to provide the personnel and facilities that Diamond State and Hallmark may each determine to be reasonably necessary in the conduct of their respective operations, including, but not limited to, accounting, tax, auditing, underwriting, claims, and support services.

Each party to this agreement is to pay its share of expenses based upon its proportionate share of the total gross direct premiums written by all parties to this agreement. Within 45 days of the end of each month, United National is to provide an itemized report to Diamond State and Hallmark indicating their respective shares of expenses. Payment is due within 15 days after receipt of each monthly expense report.

The business and affairs of United National, Diamond State, and Hallmark are to each be managed by their respective boards of directors and by their respective designated officers. United National is to act so as to assure the separate operating identity of each party to this agreement. United National personnel shall at all times remain employees of United National, and United National shall alone retain full liability to its employees for their welfare, salaries, fringe benefits, legally required employer contributions, and tax obligations. United National may decline to provide facilities requested by Diamond State or Hallmark if it would interfere with its ability to meet its obligations or would otherwise adversely affect United National.

In the event of any disagreement, the determination of the United National Group's independent certified public accountants shall be final and binding. This agreement may be terminated at any time by any party giving 30 days' written notice to the others. Each party will have the right to continue to receive data processing services or to utilize data processing facilities and related software for up to one year from the date of notice. Upon termination, each party will deliver to the others all books and records deemed to be the property of the others.

Tax Allocation Agreement

Effective July 1, 1997, Hallmark became a party to a tax-sharing agreement by and among American Insurance Service, Inc., United National Insurance Company, Diamond State Insurance Company, and itself. This agreement governs the allocation of federal income tax obligations and refunds among members of the holding company system that file taxes upon a consolidated basis with American Insurance Service, Inc. The agreement is designed to ensure that the federal income tax liability determined at the end of the taxable year of any individual insurer that is party to the agreement will not be more than it would have paid if it had filed on a separate return basis. Any participating insurer is to be paid for any foreign tax credits, investment credits, losses, or any loss carryforward generated by it, to the extent actually used in the consolidated return. Payment shall be equal to the tax savings generated by the insurer's credits, and all such payments shall be recorded on the insurer's books as contributed surplus. Once a participating insurer has been paid for its credits, it cannot use such credits in the calculation of its tax liability on a separate return basis. Any of a participating insurer's credits

which are not used in the consolidated return and for which it has not been paid, are retained by the insurer for possible future use.

All settlements under this agreement are to be made within 30 days of the filing of the applicable estimated or actual consolidated federal corporate income tax return with the Internal Revenue Service. However, when a refund is due to AIS, payment may be deferred to within 30 days of receipt of the refund. All settlements are to be made in cash or securities that are eligible investments for the insurer, at market value.

Any controversy among the participants will be settled by arbitration administered by the American Arbitration Association in accordance with its commercial arbitration rules, and judgment on the award rendered by the arbitrators may be entered in any court of competent jurisdiction. The agreement may be terminated at any time by written mutual consent, membership in the consolidated group ceases, or if American Insurance Service, Inc., and its subsidiaries fail to file a consolidated return for any taxable year.

Reinsurance Trust Agreement

On November 19, 1998, United National Insurance Company, as grantor, Hallmark, as beneficiary, and First Union National Bank, as trustee, entered into a reinsurance trust agreement. Under the terms of the reinsurance trust agreement, United National is to maintain, in trust, securities or cash with a valuation equal to the total of the unearned premium reserve, loss and loss adjustment expense reserve, and the reserve for incurred but not reported losses carried on Hallmark's books as constituting the accounts reinsured by United National. Hallmark has the right to withdraw assets from the trust account at any time, without notice to the grantor, upon presentation of written notice to the trustee. Hallmark is under a contractual obligation to apply any assets withdrawn from the account only for the following purposes:

- a. To pay or reimburse Hallmark for United National's share under the reinsurance agreement regarding any losses and allocated loss expenses paid or payable by Hallmark, but not recovered from United National, or for unearned premiums due to Hallmark, if not otherwise paid by United National.
- b. To make payment to United National of any amounts held in the trust account that exceed 102% of the actual amount required to fund United National's obligations as provided by the reinsurance trust agreement.

- c. When Hallmark has received notice of termination of the trust account, and when United National's entire obligations remain unliquidated and undischarged ten days prior to such termination date, to withdraw amounts equal to such obligations and deposit such amounts in a separate account, in Hallmark's own name, in any United States bank or trust company, apart from its general assets, in trust for such uses and purposes specified in a. and b. above to the extent not theretofore satisfied.

The purpose of the reinsurance trust agreement is to forestall the need for Hallmark to establish provisions for reinsurance as required by statutory accounting principles in the absence of such collateral. Various state laws penalize reinsurance credits due from reinsurers not licensed or otherwise approved in their jurisdiction, regardless of the specific reinsurer's financial integrity.

Holding Company Chart

The following is an abbreviated holding company chart outlining the relationships among affiliates in the United National Group.

American Insurance Service, Inc. (Pennsylvania)

American Insurance Adjustment Agency, Inc. (Pennsylvania)

International Underwriters Inc. (Pennsylvania)

J. H. Ferguson & Associates Inc. (Illinois)

Loyalty Insurance Company, Inc. (Barbados)

United National Insurance Company (Pennsylvania)

Diamond State Insurance Company (Indiana)

Hallmark Insurance Company, Inc. (Wisconsin)

V. REINSURANCE

The company's reinsurance treaties in force at the time of this examination are summarized below. The contracts contained proper insolvency provisions.

Affiliated Ceding Contracts

Type:	100% Quota Share
Reinsurer:	United National Insurance Company
Scope:	All direct business written
Retention:	None
Coverage:	100% of the risk up to \$1,000,000
Premium:	100% of the gross premium written
Commission:	5% of the premium ceded, plus commissions payable to brokers and agents on subject business
Effective date:	January 1, 1985
Termination:	By either party at any calendar quarter with 60 days' prior written notice or 15 days' prior written notice in the event of nonpayment of account
Additional comment:	This contract was amended effective December 20, 1998, to require the reinsurer to fund its obligations to the company in any manner agreeable to the company and applicable regulatory authorities so as to avoid having the company bear balance sheet penalties on unauthorized reinsurance.

Affiliated Assuming Contracts

Type:	Assumptive 10% Quota Share
Reinsured:	United National Insurance Company
Scope:	10% of net retention
Retention:	None
Coverage:	100% of risk assumed
Premium:	10% of net premiums written
Commission:	20% of premiums ceded
Effective date:	June 1, 1987
Termination:	By either party with written notice 30 days prior to the effective date at the time of termination

VI. FINANCIAL DATA

The following financial statements reflect the financial condition of the company as reported in the December 31, 1997, annual statement to the Commissioner of Insurance. Also included in this section are schedules which reflect the growth of the company, comment on any exceptional NAIC Insurance Regulatory Information System (IRIS) ratio results for the period under examination, and the compulsory and security surplus calculation. Adjustments made as a result of the examination are noted in the section of this report captioned "Reconciliation of Surplus per Examination."

Hallmark Insurance Company, Inc.
Assets
As of December 31, 1997

	Ledger Assets	Nonledger Assets	Nonadmitted Assets	Admitted Assets
Bonds	\$35,965,566	\$	\$	\$35,965,566
Cash	765,229			765,229
Agents' balances or uncollected premiums:				
Premiums and agents' balances in course of collection	590,397		54,203	536,194
Interest, dividends, and real estate income due and accrued		582,232		582,232
Receivable from parent, subsidiaries, and affiliates	1,174,204			1,174,204
Write-ins for other than invested assets				
Accounts receivable - other	<u>10,302</u>	<u> </u>	<u> </u>	<u>10,302</u>
Total Assets	<u>\$38,505,698</u>	<u>\$582,232</u>	<u>\$54,203</u>	<u>\$39,033,727</u>

Liabilities, Surplus, and Other Funds
As of December 31, 1997

Losses	\$12,188,507
Loss adjustment expenses	5,389,372
Other expenses (excluding taxes, licenses, and fees)	302
Federal and foreign income taxes (excluding deferred taxes)	85,249
Unearned premiums	1,528,798
Amounts withheld or retained by company for the account of others	10,869
Excess of statutory reserves over statement reserves	25,000
Drafts outstanding	1,038
Total Liabilities	19,229,136
 Common capital stock	 2,000,000
Gross paid-in and contributed surplus	7,831,583
Unassigned funds (surplus)	9,973,008
 Surplus as Regards Policyholders	 <u>19,804,591</u>
Total Liabilities, Surplus, and Other Funds	<u>\$39,033,727</u>

Hallmark Insurance Company, Inc.
Summary of Operations
For the Year 1997

Underwriting Income

Premiums earned	\$9,607,961
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Deductions

Losses incurred	5,953,105
Loss expenses incurred	641,824
Other underwriting expenses incurred	<u>1,119,994</u>

Total underwriting deductions	<u>7,714,923</u>
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Net underwriting gain or loss	1,893,038
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Investment Income

Net investment income earned	2,298,685
Net realized capital gains or losses	<u>75,496</u>
Net investment gain or loss	2,374,181

Other Income

Net gain or loss from agents' or premium balances charged off	<u>407</u>
Total other income	<u>407</u>

Net income after dividends to policyholders but before federal and foreign income taxes	4,267,626
Federal and foreign income taxes incurred	<u>1,007,593</u>

Net Income	<u>\$3,260,033</u>
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Hallmark Insurance Company, Inc.
Cash Flow
As of December 31, 1997

Premiums collected net of reinsurance	\$9,153,991	
Loss and loss adjustment expenses paid (net of salvage or subrogation)	5,046,488	
Underwriting expenses paid	<u>1,123,352</u>	
Cash from underwriting		\$ 2,984,151
Investment income (net of investment expense)		2,182,610
Other income (expenses):		
Agents' balances charged off	407	
Net amount withheld or retained for account of others	<u>(3,931)</u>	
Total other income		(3,524)
Deduct:		
Federal income taxes paid (recovered)		<u>(1,362,651)</u>
Net cash from operations		\$ 3,800,586
Proceeds from investments sold, matured, or repaid:		
Bonds	<u>6,304,749</u>	
Total investment proceeds		6,304,749
Cost of investments acquired (long-term only):		
Bonds	<u>5,491,760</u>	
Total investments acquired		<u>5,491,760</u>
Net cash from investments		812,989
Cash applied for financing and miscellaneous uses:		
Dividends to stockholders paid	1,000,000	
Net transfers to affiliates	<u>3,490,088</u>	
Total		<u>4,490,088</u>
Net cash from financing and miscellaneous sources		<u>(4,490,088)</u>
Net change in cash and short-term investments		123,488
Reconciliation		
Cash and short-term investments, December 31, 1996		<u>641,741</u>
Cash and short-term investments, December 31, 1997		<u>\$ 765,229</u>

Hallmark Insurance Company, Inc.
Compulsory and Security Surplus Calculation
December 31, 1997

Assets		\$39,033,727	
Less investment in insurance subsidiaries not in excess of subsidiaries' security surplus		0	
Less liabilities		<u>19,229,136</u>	
Adjusted surplus			\$19,804,591
Annual premium:			
Individual accident and health	\$	0	
Factor		<u>15%</u>	
Total			0
Group accident and health		0	
Factor		<u>10%</u>	
Total			0
All other insurance		9,452,302	
Factor		<u>20%</u>	
Total		<u>1,890,460</u>	
Compulsory surplus (subject to a minimum of \$2 million)			<u>2,000,000</u>
Compulsory surplus excess (or deficit)			<u>\$17,804,591</u>
Adjusted surplus			\$19,804,591
Security surplus:			
(140% of compulsory surplus, factor reduced 1% for each \$33 million in premium written in excess of \$10 million with a minimum of 110%)			<u>2,800,000</u>
Security surplus excess (or deficit)			<u>\$17,004,591</u>

Hallmark Insurance Company, Inc.
Reconciliation and Analysis of Surplus
For the Five-Year Period Ending December 31, 1997

The following schedule is a reconciliation of total surplus during the period under examination as reported by the company in its filed annual statements:

	1993	1994	1995	1996	1997
Surplus, beginning of year	\$ 8,520,055	\$ 8,820,401	\$ 9,595,093	\$15,845,014	\$17,553,649
Net income	1,296,822	1,769,793	2,252,911	2,769,060	3,260,033
Change in nonadmitted assets	3,524	7,787	(2,990)	(1,425)	(43,091)
Change in excess of statutory reserves over statement reserves				(59,000)	34,000
Surplus changes:					
Paid-in			5,000,000		
Dividends to stockholder	(1,000,000)	(1,000,000)	(1,000,000)	(1,000,000)	(1,000,000)
Miscellaneous adjustment	<u> </u>	<u>(2,888)</u>	<u>0</u>	<u> </u>	<u> </u>
Surplus, end of year	<u>\$8,820,401</u>	<u>\$ 9,595,093</u>	<u>\$15,845,014</u>	<u>\$17,553,649</u>	<u>\$19,804,591</u>

Insurance Regulatory Information System
For the Five-Year Period Ending December 31, 1997

The following is a summary of NAIC Insurance Regulatory Information System (IRIS) results for the period under examination. Exceptional ratios are denoted with asterisks. A discussion of the exceptional ratios may be found after the IRIS ratios.

	Ratio	1993	1994	1995	1996	1997
#1	Gross Premium to Surplus	121%	174%	83%	67%	75%
#1A	Net Premium to Surplus	75	108	54	55	48
#2	Change in Net Writings	10	55*	(17)	12	(2)
#3	Surplus Aid to Surplus	0	0	0	0	0
#4	Two-Year Overall Operating Ratio	68	71	70	68	61
#5	Investment Yield	6.6	6.5	5.8	6	6.3
#6	Change in Surplus	3	9	62*	10	13
#7	Liabilities to Liquid Assets	68	72	53	54	52
#8	Agents' Balances to Surplus	5	9	2	2	3
#9	One-Year Reserve Development to Surplus	0	(1)	(4)	(4)	(9)
#10	Two-Year Reserve Development to Surplus	(20)	(4)	(7)	(14)	(14)
#11	Estimated Current Reserve Deficiency to Surplus	(1)	28*	3	(12)	(24)

There were only three exceptional IRIS results from 1993 to 1997. In 1994, there were exceptional values for Ratio #2, "Change in Net Writings" and Ratio #11, "Estimated Current Reserve Deficiency to Surplus" of 55% and 28%, respectively. These results can be attributed to a large California building contractors' program for which the United National Group provided

coverage in 1994. The program was lost in 1995, and reserve deficiencies did not materialize in future years. The exceptional value in 1995 for Ratio #6, "Change in Surplus," resulted from a \$5,000,000 contribution to paid-in and contributed surplus from Diamond State.

Growth of Hallmark Insurance Company, Inc.

Year	Admitted Assets	Liabilities	Surplus As Regards Policyholders	Net Income
1993	\$26,472,659	\$17,652,259	\$ 8,820,400	\$1,296,822
1994	26,181,749	16,586,656	9,595,093	1,769,793
1995	33,391,585	17,546,571	15,845,014	2,252,911
1996	38,102,232	20,548,583	17,553,649	2,769,060
1997	39,033,727	19,229,136	19,804,591	3,260,033

Year	Gross Premium Written	Net Premium Written	Premium Earned	Loss And LAE Ratio	Expense Ratio	Combined Ratio
1993	\$10,709,160	\$ 6,645,629	\$ 6,453,034	78.1%	16.6%	94.7%
1994	16,691,813	10,323,697	9,219,668	75.0	12.2	87.2
1995	13,114,635	8,612,260	9,129,455	76.5	11.1	87.6
1996	11,754,975	9,677,468	10,124,486	75.1	10.8	85.9
1997	14,920,742	9,452,301	9,607,961	68.7	11.8	80.5

Since 1987, when Hallmark first began to assume risks as a member of the United National Group pool through the 10% assumptive quota share treaty, Hallmark has never ended a calendar year without both an underwriting profit and a positive net income. During the period under examination, there has been a favorable trend in policyholders' surplus and net income. The rather sizable fluctuations in premium volume from year-to-year result from the United National Group's plan of operation, which is based on program underwriting. Rather than individual policies being gained and lost from year-to-year, entire programs, which constitute distinct books of business, are gained or lost. In particular, the large increase in gross and net premium written in 1994, together with the somewhat abrupt decline in 1995, can be attributed to gaining and then losing a California building contractor's program.

Reconciliation of Policyholders' Surplus per Examination

The examination made no adjustments to the \$19,804,591 in policyholders' surplus reported by the company as of December 31, 1997. The following reclassification was proposed by this examination:

	Debit	Credit
Receivable from Parent, Subsidiaries, and Affiliates	\$453,350	
Payable to Parent, Subsidiaries, and Affiliates	<u> </u>	<u>\$453,350</u>
Total reclassifications	<u>\$453,350</u>	<u>\$453,350</u>

VII. SUMMARY OF EXAMINATION RESULTS

Compliance with Prior Examination Report Recommendations

There were seven specific comments and recommendations in the previous examination report. Comments and recommendations contained in the last examination report and actions taken by the company are as follows:

1. Management and Control – It is recommended that the company submit biographicals on all present officers and directors in accordance with s. Ins 6.52 (3), Wis. Adm. Code.

Action – Compliance.

2. Reinsurance – It is again recommended that the company either amend this reinsurance agreement to reflect UNIC as the ceding company or accurately report the agreement in Schedule F-Part-1A-Section 1 of the annual statement pursuant to the instructions of the NAIC 1992 Annual Statement Instructions – Property and Casualty.

Action – Compliance.

3. Holding Company Transactions – It is again recommended that the company pursuant to s. 617.225(1), Wis. Stat., report extraordinary dividends to shareholders to the Commissioner in writing at least 30 days prior to payment.

Action – Not applicable. The company neither declared nor paid any extraordinary dividends to its shareholder during the period under examination. The company provided written notice to the Office of the Commissioner of Insurance concerning all ordinary dividends declared and paid during the period of this examination.

4. Accounts and Records – It is recommended that the company clear out the premium suspense account of unidentified remittances on a monthly or quarterly basis so proper credit to policyholder records can be maintained.

Action – Compliance.

5. Accounts and Records – It is recommended again that the company report tax-exempt money funds as short-term investments in Schedule DA – Part 1 pursuant to the NAIC Annual Statement Instructions – Property and Casualty.

Action – Not applicable. The company did not invest its funds in any money market mutual funds at the time of this examination.

6. Investments – It is recommended that the company amend its custodial agreements to meet the standards of satisfactory safeguards and controls as outlined by the NAIC Examiners Handbook.

Action – Compliance.

7. EDP Disaster Plan – It is recommended that the company update its EDP disaster plan to include the system currently being utilized pursuant to the NAIC Examiners Handbook.

Action – Compliance.

Summary of Current Examination Results

Bylaws

The company is not in compliance with the following technical provisions of its bylaws:

1. According to Section 3.12, the executive committee and the finance committee are to have five and four members, respectively. These committees have only three members.
2. In Section 4.1, the position of general manager is designated among the principal offices of the corporation, but its duties are undefined.

The company generally appears to comply with its own bylaws, but in the foregoing instances, the company needs to amend the bylaws to reflect current corporate governance practices, or to follow the bylaws. It is recommended that the company amend its bylaws as necessary to reflect practices of corporate governance accurately.

Report of Executive Compensation

The state of Wisconsin requires each Wisconsin-domiciled insurer to file a supplement to the annual statement entitled, "Report of Executive Compensation," pursuant to ss. 601.42 and 611.63 (4), Wis. Stat. This report includes the annual compensation paid to each director, the chief executive officer, and the four most highly compensated officers or employees other than the chief executive officer. In addition, the report requires disclosure of the compensation of all officers and employees whose compensation exceeds specified amounts. For an insurer of Hallmark's size, the compensation of each officer or employee whose annual compensation exceeds \$80,000 must be disclosed.

The company failed to complete this report for 1997 in the required format. It is recommended that, in the future, the company complete and file the "Report of Executive Compensation," as required by ss. 601.42 and 611.63 (4), Wis. Stat.

Receivable from Parent, Subsidiaries, and Affiliates

The majority of transactions recorded by the company flow through the affiliated receivable and payable accounts. As previously noted, the company has no employees of its own. All operations of the company are conducted with staff provided by United National Insurance Company. United National Insurance Company initially pays nearly all expenses on the

company's behalf, except for claims, premium refunds, custodial fees, and bank charges.

Accordingly, intercompany balances are created in the ordinary course of business.

The nature of affiliated receipts and expenses, together with the methods of their allocation, appeared appropriate based on testing performed by this examination. This examination proposes no adjustment in the total amount of affiliated balances. However, certain areas require corrective action. These areas of concern include:

1. Timeliness of settlements.
2. Method of offsetting affiliated balances.

Timeliness of Settlements

The \$1,174,204 reported by the company for this line item included, among other items, a \$453,350 payable balance with Diamond State Insurance Company, a \$64,957 receivable balance from International Underwriters Inc., and a \$1,214 receivable balance from American Insurance Service, Inc. The \$453,350 payable balance with Diamond State Insurance Company was not settled until February 1999. The receivable balances with International Underwriters Inc. and American Insurance Service, Inc., had not been settled as of March 5, 1999, the final date of fieldwork for this examination. It is recommended that the company settle affiliated balances on a timely basis.

Method of Offsetting Affiliated Balances

The company reported a balance for "receivable from parent, subsidiaries, and affiliates" of \$1,174,204, while the examination resulted in a balance of \$720,854. This \$453,350 difference represents a reclassification of funds receivable from Diamond State, which the company had classified as a contra-liability in this line item as an offset to net amounts receivable from United National, International Underwriters, Inc., and American Insurance Service, Inc. While it is acceptable to offset the receivable and payable balances with respect to the same affiliate, it is unacceptable to offset amounts payable to one affiliate by amounts receivable from another affiliate for annual statement reporting purposes. It is acceptable to use journal entry offsets to minimize actual cash transactions, provided that such cash settlements as prove necessary are made on a timely basis. Accordingly, this reclassification is reflected in the section

of this report captioned, "Reconciliation of Policyholders' Surplus per Examination." It is recommended that the company discontinue the practice of offsetting affiliated balances of different companies.

Payable to Parent, Subsidiaries, and Affiliates

As of December 31, 1997, the company reported no liability for "payable to parent, subsidiaries, and affiliates," while the examination resulted in a balance of \$453,350. This examination reclassified a payable balance due Hallmark's affiliate Diamond State in the amount of \$453,350 to this line item from the line item for "receivable from parent, subsidiaries, and affiliates." This reclassification has been reflected in the section of this examination report captioned, "Reconciliation of Policyholders' Surplus per Examination." The circumstances of this reclassification have been described in the section of this examination report captioned, "Receivable from Parent, Subsidiaries, and Affiliates."

Subsequent Events

Since the conclusion of fieldwork on March 5, 1999, there have been a number of noteworthy developments with respect to the company's holding company system and advances in the company's plan of operation.

Developments with Respect to the Holding Company System

On August 27, 1999, Wind River Investment Corporation acquired 100% of the common stock of American Insurance Services, Inc., from the ten Ball Family Trusts in a tax-free exchange for an equal number of shares in the common stock of Wind River Investment Corporation. As a result of the transaction, each of the ten Ball Family Trusts owned the same percentage of the shares of Wind River Investment Corporation that they had owned in American Insurance Services, Inc. Wind River Investment Corporation was incorporated in Delaware on June 4, 1999, for the purpose of acting as a holding company for the stock of American Insurance Services, Inc. Wisconsin's Commissioner of Insurance approved this transaction on August 26, 1999, after a hearing on August 24, 1999.

On August 23, 1999, American Re Corporation entered into a definitive agreement to acquire all of the outstanding shares of American Insurance Services, Inc. Wisconsin's Deputy

Commissioner of Insurance approved this transaction on December 22, 1999, after a hearing on November 11, 1999. This agreement was terminated on August 11, 2000, on amicable terms, after the Wind River Investment Corporation exercised its right to withdraw from the agreement due to delay in obtaining regulatory consent for the transaction from the Pennsylvania Department of Insurance.

Increase in the Scope of the Company's Wisconsin Certificate of Authority

On December 9, 1999, Wisconsin's Office of the Commissioner amended Hallmark's certificate of authority to expand the scope of the company's license to include insurance and reinsurance of the following additional lines of business in the state of Wisconsin, as defined by s. Ins 6.75 (2), Wis. Adm. Code:

- (c) Disability Insurance
- (j) Credit Insurance
- (l) Legal Expense Insurance
- (m) Credit Unemployment Insurance

Expansion of Territory in which the Company is Admitted

Since the conclusion of fieldwork for this examination on March 5, 1999, the company has increased the territory in which it is licensed. By October 2000, the company was licensed in Illinois, Indiana, Iowa, Kansas, Nevada, New York, North Dakota, Ohio, South Carolina, and Wisconsin. There were license applications pending in Alabama, Colorado, Connecticut, Georgia, Louisiana, New Jersey, New Mexico, North Carolina, Oregon, and Washington.

Increase in Common Capital Stock

On August 4, 2000, Wisconsin's Office of the Commissioner of Insurance filed amended and restated articles of incorporation for Hallmark dated August 3, 2000. The only change from the previous articles of incorporation was to increase the amount of authorized stock from \$2,000,000, consisting of 20,000 shares of nonassessable voting common stock, to \$5,000,000, consisting of 50,000 shares of nonassessable voting common stock. The par value of each common share remained unchanged at \$100. An additional 22,000 shares were issued to Hallmark's sole shareholder, Diamond State, which was accomplished through the transfer of \$2,200,000 from Hallmark's paid-in and contributed surplus account to the common capital stock account.

VIII. CONCLUSION

Policyholders' surplus has increased from \$8,520,055 as of year-end 1992, to \$19,804,591 as of year-end 1997. This represents an increase of 132.4% during the period under examination.

The following schedule summarizes the cumulative increases and decreases to surplus from December 31, 1992, when policyholders' surplus was last verified by examination, to December 31, 1997:

Policyholders' surplus, December 31, 1992	\$ 8,520,055
Net income	11,348,619
Paid-in surplus adjustment	5,000,000
Dividends to stockholder (cash)	(5,000,000)
Change in nonadmitted assets	(36,195)
Change in excess of statutory reserves over statement reserves	(25,000)
Miscellaneous adjustment	<u>(2,888)</u>
Policyholders' surplus, December 31, 1997	<u>\$19,804,591</u>

The examination resulted in no adjustment to reported policyholders' surplus, thereby indicating satisfactory estimation procedures. The reclassification of this report in the amount of \$453,350, or 2.3% of reported policyholders' surplus, was made in support of a recommendation. Areas of improvement recommended by this examination included, but were not limited to, compliance with bylaws, reporting executive compensation, and timely settlement of affiliated balances.

While the company is a separate legal entity, it derives all of its net retained business through a pooling arrangement with certain affiliates led by United National. All of the company's operations are conducted by employees of United National, and the results of Hallmark's operations, other than investments, taxes, and certain types of underwriting expenses, are pooled with participants in the United National Group Pool. The experience of the company relative to net premiums, liabilities, and net underwriting results will largely, though not precisely, follow the experience of the affiliated pool as a whole. Therefore, the practices and procedures of pool participants, especially United National, which manages the pool, are critical to the operating results of the company.

IX. SUMMARY OF COMMENTS AND RECOMMENDATIONS

1. Page 29 - Bylaws—It is recommended that the company amend its bylaws as necessary to reflect practices of corporate governance accurately.
2. Page 29 - Report of Executive Compensation—It is recommended that, in the future, the company complete and file the “Report of Executive Compensation,” as required by ss. 601.42 and 611.63 (4), Wis. Stat.
3. Page 30 - Receivable from Parent, Subsidiaries, and Affiliates—It is recommended that the company settle affiliated balances on a timely basis.
4. Page 31 - Receivable from Parent, Subsidiaries, and Affiliates—It is recommended that the company discontinue the practice of offsetting affiliated balances of different companies.

X. ACKNOWLEDGMENT

The courtesy and cooperation extended during the course of the examination by the officers of the company and the employees of United National Insurance Company are acknowledged.

In addition to the undersigned, the following representatives of the Office of the Commissioner of Insurance, state of Wisconsin, participated in the examination:

Name	Title
Cruz J. Flores	Senior Insurance Examiner, Data Processing Audit Specialist
Teri M. McClintock	Financial Examiner

Respectfully submitted,

Steven J. Junior
Examiner-in-Charge